May 13, 2019

Centre Funds Insight – Spring/Summer 2019 Market Review & Outlook – U.S. Equities

The very strong rebound in U.S. stock market indexes during the first quarter of 2019, the best start since 1998, has laid the foundation for expectations that 2019 overall will be solid, as each time the S&P 500 Index has scored a gain of 10% or more in the first quarter of a year since 1935, the market managed to climb up 6% more on average for the rest of the year, with positive performance during 11 of those 12 times, 1987 being the only exception[1]. This said, it must be remembered that indexes are still just near their peak levels of last September and, furthermore, we reiterate our belief that the current market dynamics are unique despite our erstwhile attempts to find a historical analog for guidance. The two contributing attributes leading to this uniqueness are the levels of overall stock market valuation and the most important economic phenomenon that may be persistent for the next two decades, namely demographic decline in the developed economies, including China, and its impact on growth and inflation.

The catalyst behind the strong start to the year lays at the feet of Federal Reserve Chairman Jerome Powell who surprised markets by doing a complete U-turn on monetary policy. After the financial markets impact of the current rate hiking cycle began to have significance, *i.e.*, a stock market correction, Chairman Powell abruptly communicated a full reversal in short-term interest rate targets for 2019 and, not only removed expectations of further planned tightening through 2019, but instilled confidence that the Federal Reserve would actually move to accommodation with up to two interest rate cuts imbedding themselves into market expectations. Concurrently, the Federal Reserve unveiled a plan to stop scaling back the vast portfolio of bonds it built up to spur an economic recovery from the 2007-2009 financial crisis, leaving the Federal Reserve still holding at least $3.5 trillion in bonds, more than four times the roughly $800 billion it had heading into the crisis more than a decade ago. Furthermore, the European Central Bank (ECB), although it decided to end its bond purchases in December 2018, announced that it intends to continue reinvesting, in full, the principal payments from maturing securities purchased for an extended period to maintain favorable liquidity conditions and an ample degree of monetary accommodation. Never before in modern times have the world's leading central banks abandoned a monetary tightening cycle before even moving real interest rates above zero and, in the case of the Japanese and Swiss Central Banks, expanded their mandates to engage in massive purchases of equities.

The key factor that will determine whether stock markets can follow the path of history as noted above is whether the expected deterioration in earnings, anticipated for 2019 vis-à-vis 2018, can be offset with further valuation multiple[2] expansion, akin to what occurred in 2015 and early 2016 as well as other "soft landing" episodes over the past few decades, *e.g.*, 1995. The bear case would be if we had a flat or decreasing earnings environment combined with valuation multiple compression or a further de-rating. Thus, in our opinion U.S. stock market indexes offer an asymmetrical return profile from this point – up modestly with downside risk of up to 30%.

The bear case of a potential 30% plus decline in markets arises from the foundation of what is supporting market valuations currently, specifically continued low interest rates, unparalleled usage of cash flows and

[1] Source: BMO Financial Group
[2] A valuation multiple is simply an expression of market value of an asset relative to a key statistic that is assumed to relate to that value. To be useful, that statistic – whether earnings, cash flow or some other measure – must bear a logical relationship to the market value observed; to be seen, in fact, as the driver of that market value.

debt to finance stock buybacks, and perceived permanence of the recently enacted reduction in the federal corporate tax rate from 35% to 21%. With the U.S. Presidential election cycle kicking into high gear already ahead of the 2020 election, we believe the greatest risks are geared towards increasing probabilities that policies under the next administration and Congress could curtail stock buybacks and a full or partial roll-back of the corporate tax cuts. Ironically, the bear case becomes tautological and gains its own momentum if the stock market or economy falters over the next few quarters, raising the likelihood of President Trump's defeat by a progressive Democratic Party candidate who is likely to implement such changes. With regard to the permanence of the corporate tax rate cuts and the deficit, we remain old-fashioned in the belief that a dollar of debt will cut today's tax bill by a dollar, but at the cost of raising it by a dollar plus interest tomorrow. A more bullish case can be supported, returns higher than up modestly, if there is some resurgence in global growth, profit margin pressures abate, and the massive fiscal deficits being accrued from the recent tax cuts genuinely don't matter to bond or stock markets which allows the U.S. economy to potentially exit a recessionary window of vulnerability given the current low level of global growth. Alternatively, given the most recent example whereby monetary policy accommodation has come riding over the hill to "bail-out" stock markets after a greater than ten percent drawdown may lead investors to extrapolate the current re-rating phase of this stock market cycle indefinitely into the future without taking into account the effects of the normal economic and business cycles. We now find ourselves here again at peak optimism in the same manner as in 2000 and 2007 and, more importantly, witnessing deterioration in aggregate U.S. company fundamentals, operating profit margins rolling over and diminished assets efficiency, with an increasing reliance upon monetary policy accommodation to "bail-out" stock markets after significant drawdowns but leading to one of the oldest questions in investing, "how high is too high" when it comes to valuations?

With regard to economic growth, which has a strong correlation to S&P 500 Index aggregate revenues, we remain believers in our long-held thesis that demography is destiny. This holds that population trends determine the future growth rates of a country, region or even the entire world. For example, if working age populations increase too fast or too slowly, or if there are too many young or old people, then certain outcomes are likely to follow, such as economic boom or bust, inflation, or even political unrest. Low fertility and an aging population are two of our greatest concerns. In the future, nearly all developed countries may have to depend on immigrants to make up for the decline in native populations, for without them, the U.S. and nearly every country in Europe may face the prospect of a shrinking workforce and a stagnant economy akin to the Japanese experience over the recent decade. Thus, the debt crises witnessed in Greece, Puerto Rico, Italy, etc., where population declines have been most pronounced and leading, are the literal canaries in the coal mine for what experiences are likely to occur across larger countries or even regions. All developed countries have reached the point where productivity must compensate for the decline in populations or allow mass migration, which in Europe and the U.S. is one of the most argumentative and politically volatile topics and will only intensify with time. From an economic perspective, while we may experience periods of cyclical inflation, we remain convinced that lower economic growth will be consistent with continued low real interest rates and demography, more than globalization, automation, or even de-unionization, will be the primary contributor going forward.

While low real interest rates have allowed debt service levels to remain manageable, they have also led to an unprecedented increase in corporate leverage, with the debt to assets and debt per share ratios at levels last seen in the year 2000 for the average company in the S&P 500 Index. The difference, however, has been in the usage of such increased leverage. As opposed to the vast majority of cash flow usage back then being directed towards investing activities, we now are witnessing a majority directed towards financing activities, specifically stock buybacks. Corporations like stock buybacks because they generally raise earnings per share[3] by reducing the number of outstanding shares and increasing per share returns on assets and equity, used widely as performance measures for executive compensation least of all. Stock buybacks also serve as a stealth transfer of wealth from shareholders to executives as they offset the dilution from stock option issuance. In 2018, partially fueled by the lower corporate tax rates, S&P 500 constituents spent $800 billion purchasing their stock, and this year it's estimated they will spend close to $1 trillion[4], much greater than the amount distributed as dividends. The low interest rate environment may have literally trapped corporations into the classic "Minsky moment" whereby the current long period of low rates and prosperity have encouraged a diminished perception of risk, which has promoted the leveraged risk of using borrowed money instead of cash flow from operations. We believe the debt-leveraged financing of stock buybacks exposes corporations to a potential future cash flow crisis as they have underinvested in productive cash flow generating assets, which may be triggered with a short period of declining asset prices that gains furious momentum. Some of the recent notable bankruptcies of private equity owned firms, *e.g.*, food retailer Winn-Dixie Stores, highlights that even fundamentally sound and stable businesses can succumb to simply choking on too much debt, so buybacks will continue to be a major factor behind the overall U.S. market's climb, until they too exhaust themselves.

Given the "aggregate" market concerns, the process used by Centre to manage the Fund stays disciplined and focused on each individual portfolio company's growth outlook and capacity to create shareholder value, utilizing our bottom-up fundamental stock selection process. Although we derive our investment ideas on a bottom-up basis, with the slowdown in global growth and the fall in interest rates, we do expect that performance can be attained in two thematic areas – stable growth stocks and idiosyncratic restructuring stories. Regarding the former, with bond yields so low we continue to emphasize a "new Nifty-Fifty[5]" group of companies in the Fund such as Microsoft, Amazon, and Alphabet. Of course, knowing when to sell is perhaps the most critical issue but it's important also to ignore the natural human tendency to want to take profits in stocks that have had enormous run-ups, a stock like Amazon being an example, the risk being that you sell prematurely. In our view, it simply depends on the company and our ability to manage the Fund with an alertness to selling a stock if we see fundamentals deteriorate even in the slightest as we did with long-time Fund holding Nvidia during 2018, thankfully prior to its material drawdown in the fourth quarter of 2018. That said, in an environment where sales growth and margin improvement is becoming an ever-scarce attribute, many of these stocks in the new Nifty-Fifty could get more expensive with their stocks' prices relative to their earnings going much higher because of rising expectations that corporate earnings growth overall is going to slow markedly in coming years and assuming interest rates remain secularly depressed. Alternative to stable growth, we see increasing opportunities for idiosyncratic restructuring stories such as Barrick Gold, Noble Energy, AT&T, Knight-Swift Transportation, and Wells Fargo. In each case, these companies represent contrarian recovery candidates and, through our lens, have begun to fundamentally inflect positively in terms of profits margins and asset efficiency derived mainly from cost-cutting and asset restructurings with the benefit of very attractive relative, and in some cases, attractive absolute valuations.

While we admit that the three underpinnings of the U.S. stock market's excess valuation, arising from elevated profit margins, can sustain themselves for longer and, thus, keeping indexes stable until a

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[3] Earnings per share (EPS) is the portion of a company's profit allocated to each share of common stock. Earnings per share serve as an indicator of a company's profitability.
[4] Source: S&P Down Jones Indices
[5] The 50 or so stocks that were most favored by institutional investors in the late 1960s and early 1970s. Companies in this group were usually characterized by consistent earnings growth and high P/E ratios.

resumption of global growth allows earnings to grow into the existing prices to justify stability, we see fragility and indexes vulnerable to significant dislocations just lacking a catalyst. Ironically, this is at a time when market prices for forward volatility are back to near all-time lows and, thus, allowing us to efficiently purchase protective options to help insulate the Fund's underlying holdings against a material decline occurring over a short period of time in stock prices.

Whether labelled a traditional growth or value stock, we consider valuation or the price one pays at purchase as the most critical element of successful investment. Currently, the consensus driver to enable the stock market in aggregate to move higher is continued reliance upon already stratospheric valuation multiples re-rating higher still, on further accommodative monetary policies or a significant increase in risk appetite by investors, as well as momentum of highly elevated net profit margins reliant upon factors that are likely to reverse course. To repeat ourselves for emphasis, we see fragility and major stock market indexes vulnerable to significant dislocations in 2019, just lacking a catalyst. Given this, the Fund currently continues to concentrate the number of positions in its portfolio in an attempt to maximize individual stock risk rather than market risk and use derivative instruments intended to hedge the risks of existing equity positions, namely put options on the S&P 500 Index, as a potential hedge against its underlying stock holdings in the event of a material correction. We continue to emphasize a barbell[6] of secular growth stocks[7] with contrarian, opportunistic cyclical growth companies in the midst of business restructurings. We believe that our pragmatic, large-capitalization, valuation-sensitive growth and concentrated, high-conviction approach to stock selection, with a cognizance of risk management that includes tactically implementing capital protective investments, seems positioned to perform well relative to less risk aware strategies.

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James A. Abate, MBA, CPA, CFA, is the Chief Investment Officer of Centre Asset Management, LLC, and the portfolio manager of the firm's American Select Equity Strategy. He also serves as the firm's Managing Director and as the President and Trustee of the Centre Funds. Prior to founding Centre Asset Management, LLC, Mr. Abate was U.S. Investment Director, North America, for GAM. Prior to GAM, Mr. Abate served as Managing Director & Fund Manager/Head of U.S. Active Equity at Credit Suisse Asset Management responsible for its U.S. Select Equity Strategy and stable

[6] A barbell strategy in reference to a stock portfolio consists of half the portfolio anchored in defensive, low-beta sectors or assets, and the other half in aggressive, high-beta sectors or assets.
[7] A stock is secular when the associated company earnings remain constant regardless of other trends occurring within the market.

of Global Sector Funds. While at GAM and Credit Suisse, Mr. Abate achieved Standard & Poor's Funds Research AAA rating, has received numerous "Category King" mentions in The Wall Street Journal, as well as multiyear Investment Week award nominations. Prior to transitioning to asset management, he was a Manager in Price Waterhouse's Valuation/Corporate Finance Group and served as a commissioned officer in the U.S. Army and Reserves, achieving the rank of Captain. Mr. Abate holds a B.S. in accounting from Fairleigh Dickinson University and an MBA in finance from St. John's University, and is a visiting Adjunct Professor in the graduate and honors academic programs at the Zicklin School of Business, Baruch College. Mr. Abate is a contributing author to several John Wiley published books: Applied Equity Valuation, Focus on Value, Short Selling and The Theory and Practice of Investment Management; his article writings have appeared in The Journal of Portfolio Management, Investment Week, FT Investment Adviser, The Wall Street Journal, Mergers & Acquisitions and other various publications; and other writings — with Professor J. Grant, Ph.D. — on EVA, or economic value added approach to security analysis have been adopted by the CFA Institute candidate study programs. Mr. Abate is a former member of the editorial advisory board of The Journal of Portfolio Management.

About The Fund

The Fund is a U.S. large capitalization valuation sensitive growth stock fund that seeks long-term growth of capital and is focused on risk adjusted returns through active and pragmatic management; the Fund may complement its equity securities with hedges and other capital preservation strategies when deemed appropriate. The Fund is intended to be a risk managed core growth fund.

The process used by Centre to manage the Fund focuses on each individual portfolio company's growth outlook and capacity to create shareholder value, utilizing our bottom-up fundamental stock selection process. We utilize a disciplined, Economic Value Added framework to select investments. The framework focuses on the fundamentals of wealth creation or wealth destruction similar to the way a traditional, long-term focused corporate investor looking at all aspects of the business would assess a company's value. In the shorter-term, markets may often undervalue or overvalue a company's ability to create or destroy wealth. The framework seeks to identify and capture these investment opportunities. The approach is designed to capture excess returns when a business is creating shareholder wealth and the market price of the stock converges toward our target price. Centre not only analyzes earnings but also strives to understand and link the capital allocation decisions being made today by each portfolio company and how they may lead to future earnings growth. In other words, we expect that the companies in which the Fund invests will themselves invest in productive assets of the business, organically and through opportunistic purchases which, in turn, should provide the foundation for future revenue and profits growth that should create shareholder value. Alternatively, if companies cannot invest in productive assets due to a cyclical downturn or existing excess capacity, we expect these companies to "wisely contract" through the restructuring of their assets and other resources to regain their footing for future shareholder value creation. The key is that we look at the company drivers that create true shareholder wealth: capital spending or alternative capital allocations such as acquisitions, stock buybacks, or dividends; company-specific risk levels of a business to determine appropriate hurdle rates; and whether the company is generating operating returns on its underlying assets vis-à-vis the cost of capital. Wealth creation from growth or from wise contraction – that's how we believe companies create long-term shareholder value.

To meet its objective as a risk-managed growth fund, the Fund may complement its equity securities with hedges and other capital preservation strategies when deemed tactically appropriate by Centre. While the use of hedging and certain investment techniques involve risk, in accordance with the Fund's investment policies, the Adviser may tactically employ hedges and other capital preservation strategies on up to notionally one hundred percent of the value of the Fund's underlying securities positions when the Adviser's assessment of market valuation indicates forward returns for the stock market, as a whole, are low relative to downside risk and the cost to upside potential from portfolio preservation tools is deemed reasonable in order to respond to adverse market, economic, political or other conditions. The Adviser may also tactically employ hedges to reduce volatility. For example, through the tactical use of put options, the Fund may have enhanced performance and more limited risk. Index put options are designed to hedge the Fund from significant market declines that may occur over short periods of time. The value of an index put option generally increases as the underlying securities in the Fund decrease in price and decreases as those securities increase in price. The Adviser may also seek to enhance returns by writing (selling) out of the money call options tailored with exercise prices generally above the current market prices of stocks held in the Fund. As the seller of the call option, the Fund receives cash (the premium) from the purchaser. The Adviser varies its hedging strategy and defensive positions across changing market cycles but has generally employed such strategies within the Fund since late 2014.

Definitions and References

1. S&P 500 is an index of 500 stocks seen as a leading indicator of U.S. equities and a reflection of the performance of the large cap universe, made up of companies selected by economists.
2. Economic Value Added (EVA) is an estimate of a firm's economic profit - the value created in excess of the required return of the company's investors (shareholders and debt holders). Quite simply, EVA is the profit earned by the firm less the cost of financing the firm's capital. The idea is that value is created when the return on the firm's economic capital employed is greater than the cost of that capital. EVA® is a registered service mark of EVA Dimensions LLC.
3. A hurdle rate is the minimum rate of return on a project or investment required by a manager or investor. The hurdle rate denotes appropriate compensation for the level of risk present; riskier projects generally have higher hurdle rates than those that are deemed to be less risky.
4. A covered call is an options strategy whereby an investor holds a long position in an asset and writes (sells) call options on that same asset in an attempt to generate increased income from the asset. This is often employed when an investor has a short-term neutral view on the asset and for this reason holds the asset long and simultaneously has a short position via the option to generate income from the option premium. A covered call is also known as a "buy-write".
5. A put option is an option contract giving the owner the right, but not the obligation, to sell a specified amount of an underlying security at a specified price within a specified time.
6. Call options are agreements that give the option buyer the right, but not the obligation, to buy a stock, bond, commodity or other instrument at a specified price within a specific time period. The stock, bond, or commodity is called the underlying asset.

Disclosures

Investors should consider the investment objectives, risks, charges and expenses of the Funds carefully before investing.

To obtain a prospectus containing this and other information, please call 1-855-298 4236 or download the file from www.centrefunds.com. Read the prospectus carefully before you invest.

There is no assurance that this investment philosophy will consistently lead to successful investing. An Investment in the Funds involves risk, including loss of principal. The Fund is subject to risks including undervalued securities risk, portfolio turnover risk (which may result in tax consequences), and political/economic risk. Funds focusing on a single sector may experience greater price volatility.

Diversification does not eliminate the risk of experiencing investment losses.

The statements and opinions expressed are those of James A. Abate as of the date of this report. All information is historical and not indicative of future results and subject to change. Reader should not assume that an investment in the securities mentioned was or would be profitable in the future. This information is not a recommendation to buy or sell. Past performance does not guarantee future results.

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The content of this document is part of the Centre Funds semi-annual report covering the six-month period ending March 31, 2019.

Top 10 Holdings – As of 3/31/2019 (subject to change)
Microsoft Corp. 7.5%
Amazon.com, Inc. 6.0%
Alphabet, Inc. 5.8%
Facebook, Inc. 3.3%
Barrick Gold Corp. 3.2%
Exxon Mobil Corp. 2.6%
Medtronic PLC 2.5%
Visa, Inc. 2.3%
Twitter, Inc. 2.2%
Devon Energy Corp. 2.2%

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